

**The Large and Mid-Size Business Division's  
Risk Analysis Process Complies With Legal  
Guidelines, but Its Use Should Be Clarified**

**March 2002**

**Reference Number: 2002-10-072**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

March 27, 2002

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS  
DIVISION

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Large and Mid-Size Business Division's  
Risk Analysis Process Complies With Legal Guidelines, but Its  
Use Should Be Clarified (Audit # 200110042)

This report presents the results of our review regarding the risk analysis process used by the Large and Mid-Size Business (LMSB) Division. The overall objective of this review was to determine if the LMSB Division's use of the risk analysis process complies with the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> Sections (§) 1204 (a) and (b). The Treasury Inspector General for Tax Administration initiated this audit after receiving a request from a United States Senator for information about the risk analysis process.

In summary, we found that the risk analysis process used by the IRS' LMSB Division during the planning and examination of tax returns complies with RRA 98 §§ 1204 (a) and (b) for the 30 employees and managers we reviewed. However, because the process contains records of tax enforcement results (ROTERRs), LMSB Division management places employees at risk of being evaluated inappropriately. Approximately half of the employees interviewed thought the ROTERRs used in the risk analysis process could be used to evaluate individual performance in the future, although none of the employees or managers identified any instances where this had occurred.

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

We recommended that LMSB Division management issue an organization-wide communication to all LMSB Division employees and managers explaining the appropriate use of the risk analysis process.

Management's Response: LMSB Division management agreed to take appropriate action for the recommendation in this report. The LMSB Division's Strategy, Research, and Program Planning office will issue a written communication to all LMSB Division employees and managers regarding the appropriate use of ROTERS developed during the risk analysis process.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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### **Background**

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The Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division uses a risk analysis process to help achieve the goal of conducting cost-effective, quality examinations with the least burden on both the government and the taxpayer. Generally, one risk analysis is performed for every LMSB Division examination. However, one examination may include several tax returns for different tax years.

The risk analysis is a subjective process that relies on the experience, judgment, and objective analysis of the employee to establish audit and issue priorities during an examination. In performing the risk analysis, employees prioritize issues based on factors such as the taxpayer's compliance history, prior audit adjustments, estimated dollars per return, estimated dollars per issue, and estimated dollars per hour. Using the employee's estimates, the manager compares the potential benefit to be gained from examining a tax return or specific return item with the cost of the resources needed to complete the examination in determining whether the employee should conduct the examination.

Some of the factors used in the risk analysis, such as dollars per hour and dollars per return, are known as records of tax enforcement results (ROTERTs).<sup>1</sup> The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>2</sup> Section (§) 1204 (a) prohibits the IRS from using ROTERTs to evaluate employees or to impose or suggest production quotas or goals. The RRA 98 § 1204 (b) requires the IRS to evaluate employees using the fair and equitable treatment of taxpayers as a performance standard.

Prior to 1998, the IRS' performance measures focused largely on enforcement goals and productivity. At that time, employees focused on ROTERTs to achieve

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<sup>1</sup> The IRS defines a ROTERT as data, statistics, compilation of information, or a quantitative record of the tax enforcement results reached in one or more cases.

<sup>2</sup> Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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enforcement goals and management emphasized and relied on ROTERs to establish budgets and measure accomplishments. However, since the enactment of the RRA 98, IRS management has emphasized that ROTERs should not be used to set productivity goals. In a recent audit report,<sup>3</sup> the Treasury Inspector General for Tax Administration (TIGTA) reported only a few violations of RRA 98 § 1204, indicating IRS management's attention to eliminating the inappropriate use of ROTERs. In addition, the IRS implemented a new balanced system of business measures to shift the focus away from ROTERs and towards other measures, such as customer satisfaction, employee satisfaction, and business results.

The TIGTA initiated this audit after receiving a request from a United States Senator for information about the risk analysis process. Audit work was performed at the IRS' LMSB Division offices in Charlotte and Greensboro, North Carolina, and Bloomington and Brooklyn Center, Minnesota. The audit was conducted from August 2001 through January 2002 in accordance with *Government Auditing Standards*. Detailed information on the audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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### **The Risk Analysis Process Complies With Section 1204, but Employees Perceive It Could Be Used to Evaluate Individual Performance**

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The risk analysis process used by the IRS' LMSB Division during the planning and examination of tax returns complies with RRA 98 §§ 1204 (a) and (b) for all employees and managers in our sample. However, because the process contains ROTERs, LMSB Division management places employees at risk of being evaluated inappropriately. Approximately half of the employees interviewed thought the ROTERs used in the risk analysis process could be used to evaluate individual performance in the future, although none of the employees or managers identified any instances where this had occurred.

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<sup>3</sup> *Compliance With the Internal Revenue Service Restructuring and Reform Act of 1998 Section 1204 Has Not Yet Been Achieved* (Reference Number 2001-10-178, dated September 2001).

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We reviewed performance documentation for the period April 2000 through April 2001 for a judgmentally selected sample of 30 employees and managers from all 5 industries in the LMSB Division to determine if the risk analysis process was used to evaluate employees or to impose or suggest production quotas or goals. The performance documentation included Employee Performance Files, which consisted of documents such as annual and mid-year performance appraisals, self-assessments, workload reviews, and on-the-job-visit reviews. Additionally, 20 of the 30 employees and managers were interviewed to determine whether they thought the risk analysis process was used to set quotas or goals.

### **The risk analysis complies with RRA 98 §§ 1204 (a) and (b)**

Legal guidelines do not prohibit ROTERs from being used as a management tool to determine if resources are used effectively and efficiently. Collecting ROTERs for the purpose of managing resources and evaluating employees on the appropriateness of actions taken on a particular audit does not violate RRA 98 § 1204 (a). On this basis, the LMSB Division risk analysis process complies with RRA 98 § 1204 (a).

Performance documents for 10 of 30 (33 percent) employees and managers in the sample contained the phrase "risk analysis." However, because managers did not use the phrase to impose or suggest production quotas or goals, its use does not violate RRA 98 § 1204 (a).

The TIGTA's Office of Audit did not identify a connection between ROTERs contained in the risk analysis process and employee performance documents (e.g., annual performance appraisals). Employees were properly evaluated on job performance standards, such as examination techniques, tax law interpretation, taxpayer relations, and correlation of accounting entries and systems. On this basis, the LMSB Division risk analysis process complies with RRA 98 § 1204 (b).

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### **Employees perceive the risk analysis could be used to evaluate individual performance**

Most LMSB Division employees and managers interviewed thought the risk analysis process was needed to help achieve a quality work product. Although none of the employees or managers could provide examples of instances where management's use of the risk analysis process violated RRA 98 § 1204 (a), about half of the employees thought documenting the ROTERs could lead to problems in the future with the risk analysis being used to evaluate individual performance. The RRA 98 § 1204 (a) prohibits LMSB Division management from using ROTERs from the risk analysis to evaluate employees or to impose or suggest production quotas or goals.

- Nine<sup>4</sup> of 16 (56 percent) employees<sup>5</sup> thought the risk analysis could be used as a “dollar per hour” evaluation tool.
- Five of 16 (31 percent) employees did not like documenting a projected dollar impact<sup>6</sup> as part of the risk analysis.

However, 16 of 20 employees and managers (80 percent) did not think there was a connection between the risk analysis process, the job performance evaluative process, and the actual outcome of the examination. Based on discussions with employees and managers, the TIGTA's Office of Audit concluded that examiners appropriately place emphasis on performing quality examinations rather than achieving dollar outcomes.

There are two factors that may contribute to the perception that the risk analysis process could be used to evaluate employee performance.

- Some LMSB Division employees may not fully trust that their managers will use ROTERs appropriately.

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<sup>4</sup> None of the nine employees were managers.

<sup>5</sup> Of the 20 interviews with employees and managers, 16 interviews were with employees (and 4 interviews were with managers).

<sup>6</sup> Projected dollar impact consists of “dollars per return,” “dollars per issue,” and “dollars per hour,” all of which are ROTERs.



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The nine employees who thought the risk analysis could be used as a “dollar per hour” evaluation tool had all worked in the former IRS Examination Division. Prior to the enactment of the RRA 98, performance measures focused heavily on enforcement goals and ROTERs were commonly used to evaluate employee performance. For example, prior to the enactment of the RRA 98, if employees thought they could achieve a specific dollar assessment and had projected this amount as an estimated dollar impact, they were expected to achieve that assessment as a goal. This could have contributed to some employees’ perception since ROTERs were an accepted part of the evaluation process in the past.

Although the IRS implemented a new balanced performance measurement system that prohibits using ROTERs to evaluate individual performance, some employees interviewed could not definitely state that their managers would not use the ROTERs documented in the risk analysis process as an evaluation tool. In April 2000, the General Accounting Office reported<sup>7</sup> that about 9 percent of the IRS’ Examination Division employees advised that their supervisors had either inappropriately discussed enforcement statistics with them or used statistics to evaluate their performance.

The 2001 Employee Satisfaction Survey results also suggest there may be distrust between employees and their managers. Although the survey showed that 45 percent of LMSB Division employees strongly agree that there is trust between themselves and their managers, it is likely that some of the remaining 55 percent of LMSB Division employees may not fully trust management.

- Another factor that may contribute to the perception is the lack of a centralized, coordinated communication within the LMSB Division regarding the proper use of the risk analysis process.

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<sup>7</sup> *Tax Administration: IRS’ Implementation of the Restructuring Act’s Personnel Flexibility Provision* (GAO/GGD-00-81, dated April 2000).

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Since the LMSB Division became an Operating Division in June 2000, information regarding management's intended use of the risk analysis process has been inconsistently communicated among the five business industries within the LMSB Division. If LMSB Division employees were long-term examiners and had been using the risk analysis process for some time, they received little or no guidance on its use from the new LMSB Division. In contrast, new employees received formal training on its use. The training emphasizes that the risk analysis should never be used for evaluation purposes. However, because the training has not been provided for all employees, different perceptions on the purpose of the risk analysis could exist.

According to a June 2001 Business Performance Review, LMSB Division employees listed communication as one of their top six concerns. We could not determine if communication about how the risk analysis process should be used was part of their concern. Although action has been taken to improve communication, LMSB Division Headquarters management has not yet communicated an organization-wide message to its employees clarifying the appropriate use of the risk analysis.

By using ROTERs in the risk analysis process, LMSB Division management places employees at risk of being evaluated inappropriately because the ROTERs could be used as an evaluative tool. LMSB Division management should ensure all employees and managers fully understand the appropriate use of the risk analysis process and should emphasize that risk analysis data should not be used to evaluate employees or to impose or suggest production quotas or goals.

### **Recommendation**

1. The Commissioner, LMSB Division, should issue an organization-wide communication to all LMSB Division employees and managers explaining the appropriate use of the risk analysis process. The communication should emphasize that the risk analysis should never be used to

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set production quotas or goals or to evaluate individual performance.

Management's Response: The Strategy, Research, and Program Planning office will issue a written communication to LMSB Division employees and managers regarding the appropriate use of ROTERs developed during the risk analysis process. Additionally, the LMSB website will be enhanced with links to references and training material.

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### **Appendix I**

#### **Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine if the Large and Mid-Size Business (LMSB) Division's use of the risk analysis process is in compliance with the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> Sections (§) 1204 (a) and (b). We performed the following work:

- I. Determined how LMSB Division managers use the risk analysis.
  - A. Reviewed LMSB Division guidelines for the risk analysis process.
  - B. Reviewed RRA 98 §§ 1204 (a) and (b) guidance for the LMSB Division.
  - C. Interviewed LMSB Division Headquarters and field managers.
    - 1. Determined how the risk analysis process is used.
    - 2. Determined how the use of enforcement statistics to evaluate employees, or suggest production quotas or goals, is avoided during the risk analysis process.
  - D. Determined if LMSB Division managers received training on the risk analysis process and the requirements of RRA 98 §§ 1204 (a) and (b).
- II. Determined if the risk analysis process is used to evaluate employees, or to impose or suggest production quotas or goals, within the LMSB Division.
  - A. Reviewed employee and supervisory performance documentation dated April 2000 through April 2001 for a judgmental sample<sup>2</sup> of 30 of the 4,715 LMSB Division employees and managers who prepare the risk analyses.
  - B. Interviewed a judgmental sample of 20 of the 30 LMSB Division employees and managers.
  - C. Obtained Treasury Inspector General for Tax Administration Counsel's opinion on all performance documents that potentially violated RRA 98 § 1204 (a).

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

<sup>2</sup> Because individual perceptions are subjective and difficult to project across the entire LMSB Division, we decided to take a judgmental sample of employees in all five LMSB Division industry areas: Communication Technology and Media; Retailers, Food, and Pharmaceutical; Heavy Manufacturing, Construction, and Transportation; Financial Services and Healthcare; and Natural Resources. We intended to interview the same personnel that we reviewed performance documentation for; however, because of the September 11, 2001, terrorist attacks, we were able to interview only 20 personnel to obtain their perceptions on the risk analysis process.

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- III. Determined if the risk analysis process affected the fair and equitable treatment of taxpayers.
  - A. Reviewed employee and supervisory performance documentation dated April 2000 through April 2001 for a judgmental sample of 30 LMSB Division employees and managers.
  - B. Interviewed a judgmental sample of 20 of the 30 LMSB Division employees and managers.
  - C. Reviewed the balanced performance measurement system used in the LMSB Division.

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**Appendix II**

**Major Contributors to This Report**

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

Gerald T. Hawkins, Audit Manager

Catherine Cloudt, Senior Auditor

Deadra M. English, Senior Auditor

Andrew J. Burns, Auditor

Lynn M. Ross, Auditor

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner N:DC  
Director, Strategy, Research, and Program Planning LM:SR  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:RO  
Office of Management Controls N:CFO:F:M  
Liaison: Director, Communication and Liaison LM:CL

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**Appendix IV**

**Management's Response to the Draft Report**



COMMISSIONER  
LARGE AND MID-SIZE  
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

MAR 14 2002

**MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT**

**FROM:** Larry R. Langdon  
Commissioner, Large and Mid-Size Business Division

**SUBJECT:** Management Response to Draft Audit Report 2001-10-042: The Large and Mid-Size Business Division's Risk Analysis Process Complies with Legal Guidelines, But Its Use Should Be Clarified

As I reviewed your draft report, I was pleased to see that your review of the risk analysis process for the planning and examination of tax returns shows that the LMSB Division fully complies with the Internal Revenue Service Restructuring and Reform Act of 1998, Sections 1204 (a) and (b).

The issue of compliance risk is so significant to the LMSB Division that the entire area of compliance risk is one of our strategic initiatives. We use the risk analysis process to help us achieve the goal of conducting cost-effective, quality examinations with the least burden on both the government and the taxpayer. Our efforts to date have been to emphasize our responsibilities to perform quality examinations rather than to achieving predetermined production quotas or goals.

Risk analysis is the process of comparing the potential benefits of examining a return with the resources required to perform the examination. Once we consider the potential benefits and resources, we establish selection priorities. We expect our examiners to effectively manage their workload by prioritizing the returns and the issues examined so we select the issues with the highest audit potential over those with the lowest potential. This process becomes essential as our examination workload increases and our resources to handle the increased inventory remain the same or decrease.

As your report indicates, the same tools used in determining risk and making an appropriate assessment of a case, have the potential for evaluating an employee's performance, if used improperly. I was pleased to note that your interviews and reviews of performance documents did not identify such improper uses, but the perception of potential misuse is a concern.

The LMSB Division management agrees with your recommendation to use an organization-wide communication to all LMSB employees explaining the appropriate use of the risk analysis process. We will implement the following corrective action in response to your recommendation.



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### **IDENTITY OF RECOMMENDATION/FINDINGS:**

#### **Recommendation**

The Commissioner, LMSB Division should issue an organization-wide communication to all LMSB employees and managers explaining the appropriate use of the risk analysis process. The communication should emphasize that the risk analysis should never be used to set production quotas or goals or to evaluate individual performance.

#### **Findings**

- Because the Risk Analysis process contains records of tax enforcement results (ROTERTs), IRS management places employees at risk of being evaluated inappropriately. Some employees thought the ROTERTs used in the risk analysis process could be used to evaluate individual performance in the future, although none of the employees or managers interviewed identified any instances where this had occurred. Some LMSB employees may not fully trust that their managers will use ROTERTs appropriately.
- Since becoming an Operating Division in June 2000, information regarding management's intended use of the risk analysis process has been inconsistent among the five business industries within the LMSB Division.

### **ASSESSMENT OF CAUSE(S):**

As the process of risk analysis has become a more visible requirement in allocating our resources to the "next best case," we have communicated our expectations to the field offices. We will inevitably have continuing concerns about the potential for misuse that our managers can address through the proper use of this data.

### **CORRECTIVE ACTIONS:**

Although none of the managers and employees interviewed during the course of your review identified any instances where managers used ROTERTs from the risk analysis process to evaluate employees, we will ensure that all employees fully understand the appropriate use of the risk analysis process. We will also emphasize that managers should not use the data generated from this process to evaluate employees or to impose or suggest production quotas or goals.

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Our Strategy, Research, and Program Planning office will remind all of our managers and employees, through a written communication, of the proper and improper use of ROTERs developed in the course of return and issue risk analysis. Additionally, we will enhance our Intranet site to provide our employees with links to references, the Internal Revenue Manual, and training material already developed.

### **IMPLEMENTATION DATE:**

PROPOSED DATE: April 30, 2002

### **RESPONSIBLE OFFICIAL:**

Director, Strategy, Research, and Program Planning

### **CORRECTIVE ACTION MONITORING PLAN:**

We will remind our employees and managers at all levels, during the course of operational reviews, performance evaluations, and regular periodic meetings, about the proper and improper use of the data developed in the risk analysis process. We will take immediate corrective action in those situations where the facts warrant it.

If you have any questions, please contact Richard Teed, Director, Strategy, Research, and Program Planning at (202) 283-8335.